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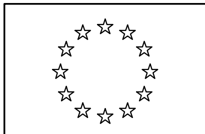

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Proposal for a Council Directive

on a common system of financial transaction tax and amending Directive 2008/7/EC

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ANNEX 17

INTEGRATION OF FAT WITH VAT

In so far as the FAT would be imposed on value added and it is argued that the FAT could serve to address the current VAT exemption of the financial sector, the question arises on the possibility to integrate the FAT with the VAT system in two different scenarios: (i) if the existing VAT treatment of financial services is kept; and (ii) if the VAT were to be applied to the financial sector. Both scenarios are analysed below.

1. FAT COMBINED WITH THE EXISTING VAT EXEMPTION.

The financial sector is subject to VAT on its inputs like most other industries. However, the exemption of financial services under Article 135 of the VAT Directive means that much of this VAT is non-recoverable so it is a real cost to the sector. The outcome is that the sector is taxed on its inputs.

If this cost is passed on to the customers of financial institutions in full and consistently, then when compared with full taxation business customers (B2B transactions) are overtaxed and private consumers (B2C) are undertaxed.

The impact of non-recoverable VAT is not transparent but a number of factors point to its being extremely uneven. The consequence is that similar activities or bundles of activities will not bear the same tax burden in different Member States. There are many reasons for this inconsistent taxation but the more important ones fall broadly under the following headings:

1.1. Differences in recovery rates

Although the VAT Directive requires that the rules on non-recoverability of VAT should be harmonised and deduction calculated similarly in all Member States and lead to similar results, this does not happen in practice. Differences in interpretation of EU law and concessional national practices (not always documented) are conducive to inconsistencies in recovery rates[1]. Furthermore, because there is no agreed common methodology for measuring the turnover of a financial institution for VAT purposes, the same accounting data can give different recovery rates in different Member States. This affects the amount of tax actually paid.

1.2. Option to tax

As allowed under Article 137.1 (a) of the VAT Directive, 6 Member States, each taking a different approach, allow the supplier of some financial services to opt to tax them. This

[1] For more information see report from IBFD on Survey on the recovery of input VAT in the financial sector (January 2007) available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/vat_insurance/vat_survey_financial.pdf

is likely to have a significant impact on the amount of non-recoverable VAT borne by the supplier. Some tax may be generated on supplies tofinal consumers. Where the option is applied only to B2B, it is possible that this part of the financial services provided is not burdened with VAT at all.

1.3. Differences in VAT rates

Some part of the difference in non-recoverable input VAT paid can be attributed to the possibility for Member States to apply a different level for their standard rate. These vary between 25% and 15%.

Moreover, it is not easy to observe and quantify either the total tax revenue collected by Member States attributable to non-recoverable input VAT on financial institutions or the level of such taxes borne by individual institutions.

The base line scenario for the VAT exemption therefore is both difficult to identify and not secure. There is little guarantee that comparable financial institutions will have comparable tax burdens, particularly if they are established in different Member States. If a FAT were to be integrated with VAT, this would have to be achieved in an environment where VAT is not a constant factor.

Were FAT to be computed on the same taxable base as VAT under an exemption model (*i.e.,* on inputs), some methodology would be needed to compensate for the fact that not all inputs bear VAT consistently and some not at all.

Were FAT to be computed on a "value added" defined per financial institution, the reality that institutions bear different levels of input VAT may be significant and would need to be taken into account.

In assessing the potential for integrating FAT with VAT, much would depend on what is the desired overall outcome. If it is primarily to increase the tax contribution from the sector, then the uneven impact of the VAT exemption should not be a limitation and a FAT could be levied in an independent manner. If however what is being sought is to tax financial activities (under both VAT and FAT) in a manner which is both consistent across the sector (and aims at creating a level playing field) and also increases the overall tax take, then the unevenness in the tax burden under the existing VAT model would be problematic and would need to be tackled.

Whilst it is to be hoped that the current negotiations in the Council on the modernisation of the VAT exemption[2] will in time lead to a more consistent VAT treatment, this would

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[2] COM (2007) 747 Proposal for a COUNCIL DIRECTIVE amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services and COM (2007) 746 Proposal for a COUNCIL REGULATION laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial services.

not be enough to eliminate the variations in the actual burden of non-recoverable VAT between Member States.

A more consistent outcome might be achieved if a FAT/VAT integrated system was based on using outputs for VAT purposes as a common taxable base (in other words, if financial services were fully subject to VAT). The usual reason given for VAT exemption for financial services is the difficulty with computing the tax base (for outputs). This however may not be a totally valid response and some consideration is merited as to whether this apparent obstacle can be overcome in practice. However, a full VAT application is likely to result in higher prices of some financial services for final consumers (B2C).

2. FAT COMBINED WITH A FULL APPLICATION OF VAT.

Several models have been advanced which would allow for the charging of VAT on financial services. Although they are often perceived as suffering from deficiencies which render them problematic, they also point to taxation as being technically feasible even if the solution lacks elegance. If the case for exempting VAT from financial services is essentially a negative one, predicated on deficiencies in the alternatives of taxation, some thought should be given to whether the complexity, uncertainty and inconsistency inherent in exemption really produce a better outcome.

2.1. Tax calculation account method (TCA).

This was developed by E & Y for the Commission and, based on cash flows, seeks to measure the margin from financial intermediation services on a transactional basis consistent with invoice credit VAT. The Commission's assessment was that its complexity rendered it unsuitable for legislation. Nevertheless, the TCA method confirmed that it was technically feasible to apply VAT to financial services.

2.2. Modified reverse charge.

Howell Zee of the IMF has devised a model for taxation based on a transaction-by-transaction franking system which is generally seen as compatible with the normal VAT system. It has however never been tested in practice.

2.3. European Banking Federation (2009).

A report commissioned by the EBF from E & Y concluded that a simplified margin based system could be implemented but for practical and competitive reasons, a zero rate should be applied to B2B transactions.

Although this report was envisaged in the context of the more extensive option to tax proposed by the Commission in 2007, the underlying accounting-based concepts could equally be applied in a more general taxation scheme.

2.4. Ad-hoc methodologies in various Member States.

Those Member States which allow the option for taxation on margin based transactions have adopted rules or practices for determining the taxable base for these transactions.

There is no common methodology and in many cases the computation of the taxable base is ad-hoc and even crude. In some instances, gross interest is accepted as a basis for taxing interest on loans although this is conceptually flawed and leads to exaggerated recovery rates (which may in practice be the intention).

None of these are perfect solutions but would seem to confirm that it is technically possible to apply VAT (and in the case of the option to tax, this actually happens in practice), albeit that significant further development work would seem to be needed. Such a perspective seems to underlie the conclusions adopted by EcoFin in November 2010 where the Commission was asked to pursue further work on the identification of the taxable base in collaboration with the Member States and to explore solutions which allow for a departure from the existing VAT exemption[3].

Ending the VAT exemption means that VAT on financial services would function as VAT normally does – as a tax on final consumption by consumers. Normally VAT would not fall as a charge on business that will be able to recover input tax.

Integrating FAT with VAT under a full VAT taxation system would start with some advantages (notably a consistent tax base) but also raise some questions. The amount of tax collected (as a function of the consumption by households of financial services) gives a clear base-line but questions would then arise as to how extensive FAT should be. Should it be an additional levy, parallel in scope but in addition to VAT or should it aim at a wider coverage?

Under full taxation, VAT would generally be recoverable for business clients. In so far as FAT is conceived as a non-recoverable tax, the impact of an integrated VAT/FAT would be mixed. As a rule, FAT would be borne directly by the financial institution whereas VAT would fall on the consumers of the financial services which it delivers.

3. CONCLUSION

The extent that some existing taxes on the financial sector (other than non-recoverable VAT) in certain Member States are linked to VAT, at least partially, opens up a possibility of a linkage between VAT and FAT on a more consistent basis. For instance, the *taxe sur les salaires* in France is payable in inverse proportion to the extent to which a financial institutions activities are subject to VAT. If for example, 20% of its outputs are subject to VAT then 80% in value (100% minus 20%) of salaries are subject to this tax. As mentioned elsewhere in this document, defining the financial institutions that would become subject to FAT by reference, amongst other criteria, to some other VAT concept (such as the recovery pro-rata) would also be a possibility.

This takes account of the reality that the activities of most financial institutions for VAT purposes are a mixture of taxable and exempt. For FAT, a linkage of this nature to VAT might be considered as a first step in establishing a taxable base. The rate to be applied could then be fixed in the context of broader policy objectives.

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[3] Beyond mentioning the EcoFin conclusions and the obligation to continue work on the taxable base, this note does not consider the wider social and political context of removing the VAT exemption for financial services.

If it is considered desirable to integrate VAT and FAT (for whatever reason), this might be seen as a reasonable degree of linkage in the current circumstances. Were the VAT exemption ever to be replaced at some point in the future by full taxation, the concept would obviously have to be reconsidered. In the meantime however, some particular consideration would have to be given to how to apply FAT for the very limited number of financial institutions whose turnover is fully subject to VAT under the existing option to tax.